

IS AMERICA BECOMING GREECE?

Michael Tanner

It does not take more than a glance at the headlines to see that European countries are in trouble. From Greece to Britain, from France to Portugal, it is becoming clear that the modern welfare state is unsustainable, facing fiscal catastrophe, stagnant economic growth, punishing taxes, and prolonged joblessness. European countries are being forced, kicking and screaming, to rethink their approach to social welfare. But how much better off is the United States?

According to the Congressional Budget Office, the United States will run a budget deficit in 2013 of roughly \$940 billion (CBO 2013). However, because this does not include “emergency” and other unbudgeted expenditures, it is likely that our deficit will actually exceed \$1 trillion for the fifth consecutive year. Indeed, Congress recently approved a relief bill for victims of Hurricane Sandy that will add an additional \$51 billion to this year’s deficit. And, while deficits are projected to decline slightly between 2013 and 2018, they are expected to begin growing rapidly once again thereafter, particularly once entitlement programs begin a period of explosive growth after 2020.

Cumulatively, our ongoing budget deficits have resulted in an official national debt of \$16.4 trillion as of January 2013. While this includes both debt held by the public and intra-governmental debt, it does not include the future unfunded liabilities of entitlement programs such as Social Security or Medicare. Those “implicit” obligations add tens of trillions in additional debt to our national balance sheet.

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As noted, the United States is hardly unique in facing a mounting debt crisis. The Greek, Irish, and Portuguese governments alone owe some €650 billion (roughly \$1 trillion). Spain owes nearly as much as those three combined, €640 billion, while Italy and France each owe more than €1.8 trillion. All told, EU countries owe almost €11 trillion (European Commission 2013a). And, that is just the debt that is on the books. If one includes the unfunded liabilities of their pension and health care systems, Europe is well over €100 trillion in debt.

Europe's debt problems have generated enormous economic and social instability. Indeed, the fate of the euro itself has become uncertain. The ultimate fallout is likely to be worldwide, including a continued slowing of U.S. economic growth.

Europe's ongoing debt crisis provides an extraordinary laboratory, enabling us to view the results once the modern welfare state becomes unaffordable. The instability being seen in Europe today presents the likely endpoint for this country unless we are able to put our economic house in order. The question becomes relevant therefore: How far has the U.S. traveled down the road toward a European-style debt crisis.

Europe's Debt Crisis

Both short-term budget deficits and long-term debt have reached crushing levels in nearly all EU countries. In 2011, the average EU nation ran a deficit equal to 4.4 percent of GDP, but many countries faced much bigger shortfalls. Three EU countries—Ireland (13.4 percent), Greece (9.4 percent), and Spain (9.4 percent)—had budget deficits in excess of 9 percent of GDP (European Commission 2013b).

If rising annual budget deficits represent year-to-year cost of the welfare state, the cumulative total of that profligacy is the national debt, which has now reached an average of 85 percent of GDP. Greece, Italy, Portugal, and Ireland had a total national debt in excess of 115 percent of their GDP, and Belgium was close behind at almost 102 percent. In all, 14 countries (Austria, Belgium, France, Germany, Great Britain, Greece, Hungary, Ireland, Italy, Malta, the Netherlands, and Portugal were joined by Cyprus and Spain) had debt ratios higher than the 60 percent of GDP mandated by the Maastricht Treaty that created the eurozone (European Commission 2013a).

It could be argued, of course, that a significant portion of this debt is due to the recession, which both drove down economic growth and revenues and increased countercyclical spending. Programs such as unemployment insurance and income support measures naturally spend more during an economic slowdown. In addition, most nations undertook various Keynesian stimulus measures to spur growth, although those stimulus measures were more limited than those in the United States. And several nations, notably Ireland and Spain, intervened to bail out their banking sectors. As a result, publicly held debt was 32 percent higher by the end of 2011, on average, than before the recession began (European Commission 2013c). As those programs terminate and economic growth resumes, debt-to-GDP ratios will likely decline in the short term. If so, countries are not as close to their debt limits as a current-time snapshot would seem to indicate.

However, it should be noted that most European countries had a substantial debt load even before the recession. Debt-to-GDP ratios in countries that now make up the EU are generally higher today than they were at the end of the Great Depression, although crisis-related factors were similar. This suggests that the current debt levels cannot simply be blamed on the recession (see Abbas et al. 2010). Those countries that had accumulated large debts had no margin to spend more once the recession hit. Moreover, even if they can reduce their debt to pre-recession levels, they will still be in a perilous financial condition.

Most published reports on the size of Europe's debt understate the problem. That is because they only consider one type of debt, "debt held by the public," which is primarily those government securities owned by individuals, corporations, foreign governments, and other entities.

A country's actual level of indebtedness, or fiscal imbalance, therefore, is most properly considered as the difference between the cost of continuing current government spending programs, including promised benefits under pension and health care programs, as well as existing public (and intergovernmental) debt, minus anticipated tax revenues. Expressed in terms of "net present value," it represents the best estimate of the resources that a government would have to have today, invested and earning interest, in order to pay for current policies in the future. More simply, a country's total indebtedness/fiscal imbalance is the gap between

future spending and future revenue embedded in current fiscal policies.

For instance, while Great Britain's official debt is £816 billion, an all time high, its actual debt is as much as £4.8 trillion. Therefore, if Britain hopes to meet all its future obligations, it would need to have an additional £4.8 trillion on hand today that it could invest at standard interest rates.

The real indebtedness of most European countries is several times larger than the value of all goods and services produced in those countries over the course of a year (GDP). Britain owes 333 percent of its annual GDP, but that is actually better than most of its peers; France, for instance, has unfunded liabilities in excess of 549 percent of GDP; not surprisingly, Greece is in the worst trouble of any country not facing a post-Soviet debt, with unfunded obligations in excess of 875 percent of its GDP (Gokhale 2009).

Even measured against total future GDP, European debt burdens are enormous, averaging 8 percent of all future economic output (Gokhale and Partin 2013). This would be, of course, on top of current levels of government consumption, which could reasonably be expected to continue. But is the United States appreciably better off?

Comparing the U.S. and European Debt Burdens

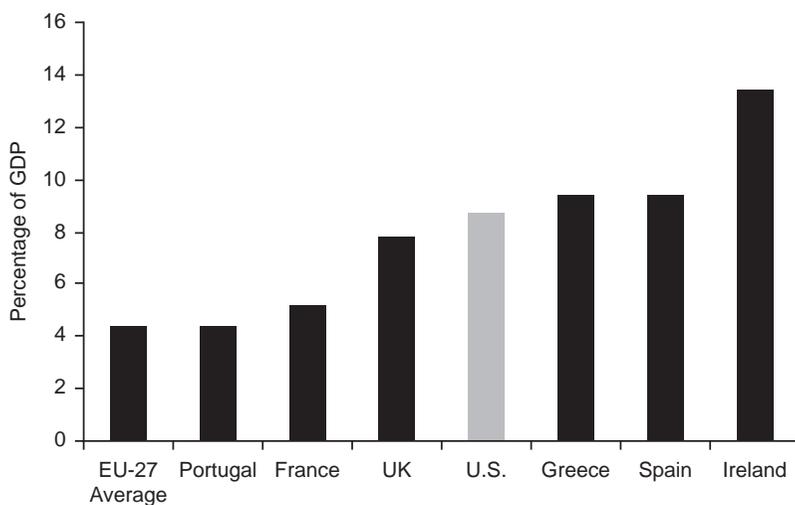
The U.S. federal budget deficit in 2011, the last year for which comparable EU data are available, was roughly 8.7 percent of our GDP. As Figure 1 shows, that means our deficit was a larger proportion of the economy than the deficits of any EU country except for Greece, Spain, and Ireland. Since then, our deficit has declined to just 6.9 percent of GDP. However, that still leaves us with a larger deficit-to-GDP ratio than the majority of EU nations.

While some might dismiss this as a short-term phenomenon, driven by the recession and the remainder of the economic stimulus bills, the larger debt picture is hardly better. The \$16.4 trillion U.S. national debt amounts to roughly \$52,000 per person. That means that every American man, woman, and child owes more than the citizens of any EU country (Figure 2).

Of course, Americans are wealthier than their European counterparts. To take that into account, a better measure therefore is to again compare our debt to GDP. By this measure, we fare a bit better, but not much. Compared to EU countries, the U.S. national debt is larger, as a percentage of GDP, than that of all but four

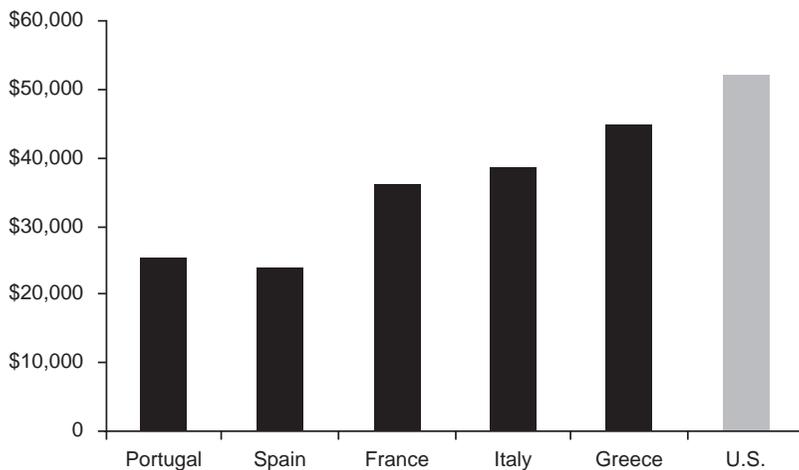
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FIGURE 1
ANNUAL BUDGET DEFICITS OF SELECTED COUNTRIES, 2011



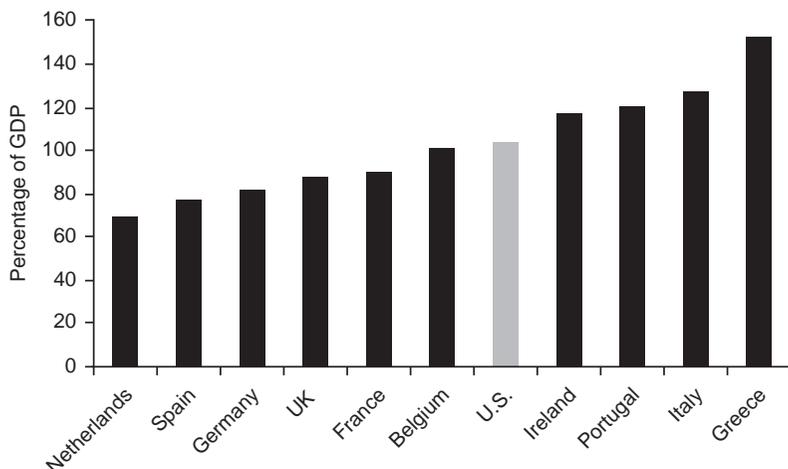
SOURCES: Eurostat, OMB.

FIGURE 2
NATIONAL DEBT PER PERSON: U.S. (2013), EU (2011)



SOURCES: Author's calculations using Eurostat, Department of the Treasury (2013).

FIGURE 3
GOVERNMENT DEBT OF SELECTED COUNTRIES:
U.S. (2013), EU (2011)



SOURCE: Eurostat, Department of the Treasury (2013).

EU nations: Greece and Ireland again, as well as Italy and Portugal (Figure 3).

But the official measures of national debt actually understate the true level of a nation's indebtedness. While it includes both debt held by the public and intragovernmental debt (debt held by the government itself, such as the U.S. Social Security Trust Fund), it does not include implicit debt or the unfunded obligations of pension and health care programs, that is, the benefits promised under those programs in excess of anticipated revenues.

Those obligations, of course, represent the "softest" form of debt, in that there is no legal requirement to pay all the promised benefits. But "soft" does not mean debt that can be completely dismissed. Future promises to pay benefits are generally categorized as debt according to Generally Accepted Accounting Principles (GAAP) and other accounting authorities. Therefore, if the government were required to report its debt in the same way public companies do, those promises would show up as debt.

For the United States, as for most countries, such implicit debt dwarfs the explicit debt. For example, Social Security's future unfunded obligations now run to more than \$20.5 trillion. Medicare's

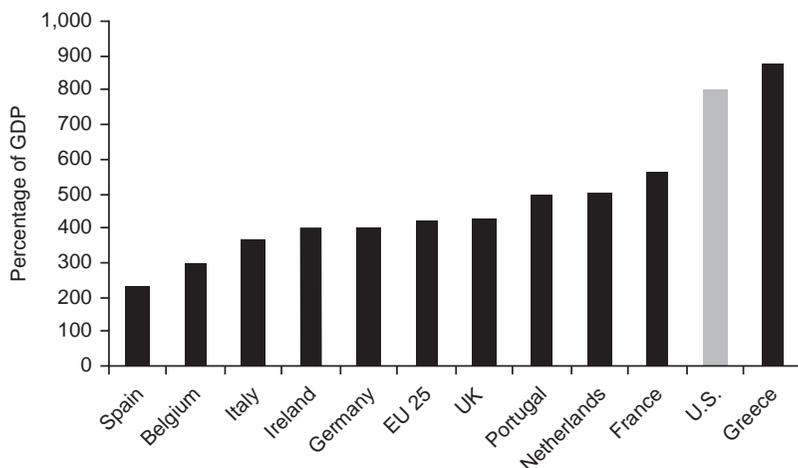
unfunded liabilities are more difficult to nail down, in part because of the uncertainty brought about by the new health care reform law, but run at to at least \$42 trillion. And, if the Affordable Care Act fails to reduce health care costs as predicted, Medicare's liabilities could be as high as \$89 trillion.

Therefore, real U.S. indebtedness, taking into account both explicit and implicit debt, actually totals at least \$79 trillion, equal to more than 500 percent of GDP. And if the projected savings in Medicare do indeed prove unrealistic, our debt could run as high as \$127 trillion, an inconceivable 800 percent of GDP.

Measuring this total indebtedness against similar measures for other countries, shows just how bad the U.S. situation potentially is. Even under the best-case scenario, the United States is deeper in debt than Ireland, Italy, Spain, or the United Kingdom. And, if the more pessimistic projections prove to be correct, the United States is actually deeper in debt than any country in Europe except for Greece (Figure 4).

Of course, these future liabilities will not be paid out of today's economic production but from future economic production. In addition, measurements of the discounted present value of future

FIGURE 4
UNFUNDED OBLIGATIONS AS A PERCENTAGE OF GDP:
U.S. (2013), EU (2004)



SOURCES: Author's calculations using OMB, Gokhale (2009).

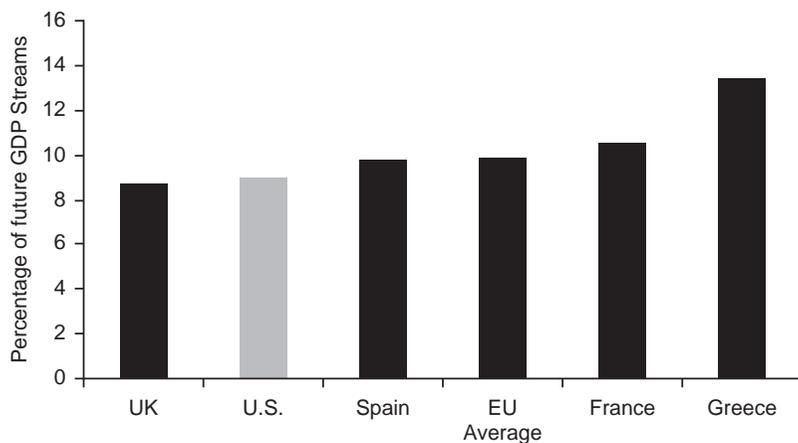
liabilities are extremely sensitive to assumptions about future interest/discount rates. Therefore, a better way to calculate the size of true national debt is to measure the proportion of a country's future GDP stream that will be required to finance that debt.

As Figure 5 shows, the average European country will have to spend 9.9 percent of its GDP every year—forever—just to pay for its debt, while the United States faces a debt equal to 9 percent of its future GDP stream (Figure 5).

However, this may underestimate the burden required to pay the debt, because a country's tax base is only a fraction of its GDP. Accordingly, the tax increases required to pay the debt would need to be substantially higher as a proportion of current taxes than as percentage of GDP. Taxes at such levels would almost certainly depress both investment and consumption, depending on the distribution and composition of the taxes, substantially slowing economic growth.

The International Monetary Fund looked at the relationship between debt and economic growth, concluding that, from 1880 to 2009, those countries with high debt levels consistently experienced slower economic growth than those with low debt levels (Abbas et al. 2010). Similarly, Carmen Reinhart and Kenneth Rogoff (2010) concluded that countries with a debt totaling more than 90 percent of

FIGURE 5
PERCENTAGE OF FUTURE GDP NEEDED TO PAY DEBT



SOURCE: Gokhale and Partin (2013).

GDP have median growth rates 1 percent lower than countries with a lower debt, and average growth rates nearly 4 percent lower.

The slow economic growth that the United States has seen coming out of the recession may be evidence that we are already seeing some consequences from our debt overhang. However, if we have not yet suffered the consequences of such debt in the same way as Europe, it is because the United States has certain economic advantages that have shielded us so far. The first of these is the simple size of the U.S. economy. U.S. GDP is nearly 50 percent greater than that of China, the world's second largest economy, and not much less than the combined GDP of all 27 EU nations. This allows the United States to absorb more debt than smaller economies.

Second, the U.S. dollar remains the world's dominant reserve currency, representing roughly 62 percent of global reserves, compared to roughly 26 percent for the euro (IMF 2013). As the Congressional Research Service notes, "Investors may be willing to give up a significant amount of return if an economy offers them a particularly low-risk repository for their funds. The United States, with a long history of stable government, steady economic growth, and large, efficient financial markets, can be expected to draw foreign capital for this reason" (Elwell 2012). The risk of inflation, devaluation, or default on U.S. debt instruments is perceived as being relatively low.

The deterioration of Europe's fiscal situation has actually strengthened the U.S. position as a "safe haven" for investment. This is not because of any strength or improvement to the U.S. fiscal balance, which has grown worse in recent years, but because of the even more rapid increase in European debt and the accompanying market turmoil. The United States becomes the best of possible bad options.

The United States also controls its own currency, giving it more flexibility in managing short-term economic fluctuations. As a result, investors, both at home and abroad, have been willing to lend money at extremely attractive rates. But we should not assume that such favorable borrowing conditions will continue indefinitely. As one senior Chinese banking official noted, "We should be clear in our minds that the fiscal situation in the United States is much worse than in Europe. In one or two years, when the European debt situation stabilizes, attention of financial markets will definitely shift to the United States. At that time, U.S. Treasury bonds and the dollar will experience considerable declines" (Xin, Rabinovich, and Yao 2012).

If there were a loss of confidence in U.S. debt, the government would have to hike interest rates in order to continue attracting investment. Without specifically naming Greece or the EU, the Congressional Budget Office nevertheless warns that “as other countries’ experiences show, investors can lose confidence abruptly and interest rates on government debt can rise sharply and unexpectedly. The exact point at which such a crisis might occur for the United States is unknown, in part because the ratio of federal debt to GDP is climbing into unfamiliar territory” (CBO 2010).

Over the past two decades the average rate of interest on government debt has been 5.7 percent. If interest rates were to return to anything close to traditional levels, it would add trillions to our future obligations. For example, according to CBO, if the interest rate on Treasury securities were 1 percentage point higher in each year, net interest payments would be higher in each year by amounts rising from \$13 billion in 2011 to \$185 billion in 2020. From 2011 through 2020, total interest costs would be higher by more than \$1 trillion (CBO 2010).

This is the same tragic cycle currently experienced by countries such as Greece, Spain, and Italy. They continue to deficit-spend, requiring them to borrow additional money in order to fund their government. Yet, because of their enormous debt burden, investors require extremely high interest rates as a condition of lending them more money. The interest payments add significantly to their debt burden, driving up total debt and crowding out other expenditures. Only the intervention of the IMF, the European Central Bank, and the EU itself has prevented countries such as Greece from defaulting on their debt, with all the catastrophic consequences that would ensue.

Should U.S. interest rates spike, we could easily find ourselves facing a similar death spiral. However, in our case, there is no outside entity capable of intervening.

In 1979, for example, when the U.S. economy was pummeled by stagflation, the oil embargo, and a weakening dollar, President Carter introduced a budget with deficits much deeper than had been predicted. International markets plunged into turmoil as the value of the dollar collapsed. Within a week, the Federal Reserve was forced to raise interest rates sharply, leading to a recession that stretched into 1982 (Goodfried 1993).

Given the much higher debt levels we currently face, the reaction could be much larger and sharper than it was in 1979. The Congressional Budget Office warns that such a spike in interest rates would lead to huge losses for bondholders, possibly precipitating a major economic crisis that “could cause some financial institutions to fail” (CBO 2010: 7).

To see how close the danger is, one need only look to recent declines in the U.S. credit rating. In 2011, Standard and Poor’s downgraded the U.S. from AAA to AA+. That now puts the U.S. creditworthiness in the same category as the Isle of Man, France, and Guernsey, and below that of such countries as Australia, Finland, and Liechtenstein (Standard and Poor’s 2013).

The Burden of Big Government

The debt numbers discussed above may be frightening, but focusing on them is to confuse the symptom with the disease. As Milton Friedman often explained, the real issue is not how you pay for government spending—debt or taxes—but the spending itself.

Of course some government spending is necessary. Governments must provide certain basic services such as adjudicating disputes, maintaining police and defense functions, and, arguably, maintaining the infrastructure necessary for a functioning economy. Thus, under a scenario with zero government spending there would be little if any economic growth.

But beyond a certain level, nearly all economists would agree that the costs of government exceed the benefits it provides, leading to lower economic growth. For example, if government consumed 100 percent of GDP there would be little or no economic growth. In between is a curve, with rising initial growth accompanying increased government spending, followed by declining growth once government gets too large.

As Gwartney, Lawson, and Holcombe (1998: v) argue:

As governments move beyond these core functions [of protecting people and property], they will adversely affect economic growth because of (a) the disincentive effects of higher taxes and crowding-out effect of public investment in relation to private investment, (b) diminishing returns as governments undertake activities for which they are ill-suited, and (c) an interference with the wealth creation process, because

governments are not as good as markets in adjusting to changing circumstances and finding innovative new ways of increasing the value of resources,

Economists debate the slope of that curve, but few would argue that government can consume an unlimited proportion of the national economy without it having a significant impact on that economy. Estimates of the optimal size of government range from 17 to 40 percent of GDP, with the vast majority suggesting a range of 20 to 30 percent (see Barro 1989, Karras 2002).

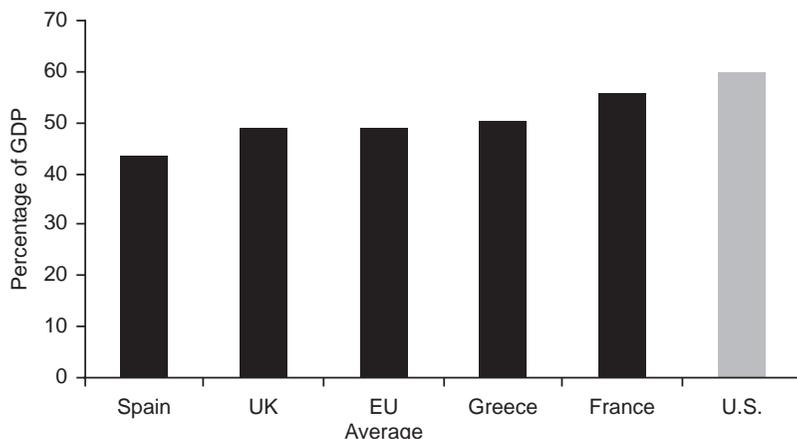
On average, governments (at all levels of government) in EU countries today consume almost 45 percent of their GDPs. Spending by the federal government in the United States amounted to 22.9 percent of GDP in 2012, well below European averages, though well above historical U.S. averages. However, if one includes state and local spending, total government spending in the United States reaches 34 percent of GDP, much closer to European levels. Worse, assuming there is no change in the current baselines, by 2050 federal government spending will exceed 46 percent of GDP. Adding in state and local spending, government at all levels would be consuming around 60 percent of GDP, considerably higher than the current government to GDP ratio that European countries face today (GAO 2012, CBO 2012). Whether financed through debt or taxes, government that large would represent a crushing burden to the U.S. economy (Figure 6).

Conclusion

The United States faces a massively growing debt that threatens our economic future. But as bad as that debt is, it is merely a symptom of a larger disease: a rapidly growing government that is consuming an ever larger share of our national economy. As a result, the United States is well down the road toward a debt crisis similar to Europe's. That we haven't already experienced such a crisis is the fortuitous result of the U.S. position as the world's key reserve currency combined with the overall strength of our economy. But that will not protect us forever.

Unless the United States learns from the failure of Europe's welfare state and acts now to reduce spending, reform entitlements, and reduce the growing burden of government, we will eventually find ourselves in the same situation as Greece.

FIGURE 6
 PREDICTED U.S. TOTAL GOVERNMENT EXPENDITURES IN
 2050 COMPARED TO CURRENT GOVERNMENT
 EXPENDITURES IN SELECTED EU COUNTRIES



SOURCES: Eurostat, GAO, and CBO.

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